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Are We at the Inflection Point of Climate Change Investing?

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Received wisdom in financial markets is being challenged by rising concerns with sustainability, as human economic activity stresses planetary boundaries and societal expectations for shared prosperity rise globally. The adoption of the UN Sustainable Development Goals by close to 200 nations in 2015 is one sign of the shared global ambition to tackle climate change, eradicate poverty, end hunger, foster productive work and education, ensure gender equality and protect the natural environment.[1] Finance will play a vital role in achieving these goals. However, there is a gap between the demand for capital to respond to the risks and opportunities of sustainability, and the enablers of supply, which would allow the financial markets to allocate capital efficiently. The result is more noise than signal.

The breadth and depth of climate change issues test conventional appraisal of risk and return. The question for investors is whether capital markets are at an inflection point that could bring rapid, transformative and potentially disruptive changes. If so, how can investors ride the waves of change, which are driving both risk and opportunity in finance? In navigating the potential turbulence ahead, we need to close the gap between the demand for finance to address climate change, and the current constraints on supply capacity for markets to efficiently price those risks and opportunities.

We identify two broad sets of constraints: (1) lack of investment-grade climate-disclosure data and analytics (usually as part of the broader ESG data disclosure and analytics), and (2) misaligned incentives (e.g., presence of fossil fuel subsidies and absence of carbon pricing).

The ESG Gold Rush

Despite the hazy definitions, the ESG trends in finance have brought a veritable gold rush to the capital markets. According to Morningstar, in the fourth quarter of 2020 alone, investors directed US$152 billion into investments marketed as ESG, an 88% rise from the previous quarter.[2] CNBC commented that by year end, sustainable investing of some variety now accounts for about a third of total assets under management in the United States.[3]

A large portion of the asset management industry now claims ESG credentials, but this in turn has prompted questions as to whether the marketing claims are entirely credible. A study by Barclays concluded that the holdings and risk exposures of ESG-labelled funds are not really different from those of conventional funds.[4] The concern that ESG suffers from is "virtue signalling" which could mislead investors, prompting a risk alert from the US Securities and Exchange Commission (SEC), which stated: "firms claiming to be conducting ESG investing need to explain to investors what they mean by ESG and they need to do what they say they are doing" so "investors know what they are getting when they choose a particular fund, advisor, strategy or product."[5]

This warning shot from the US regulator has come alongside a new push to develop standards for reporting by companies on ESG, both internationally via the new International Financial Reporting Standards (IFRS) International Sustainability Standards Board and proposed rulemaking on climate change at the SEC. The SEC risk alert shows that the investment management industry itself will not be exempt from scrutiny. Notwithstanding the uncertain status of ESG claims, the furious speed of money flooding into funds claiming sustainability credentials shows that financial markets could be recognising an inflection point on the horizon.

What then, in financial markets, do we mean by an inflection point? Essentially it is when everything changes rapidly, at pace and scale. A vivid example is the energy transformation in transport, which has led to electric vehicle manufacturer Tesla outranking competitors reliant on the internal combustion engine fuelled by carbon heavy gasoline and diesel. An inflection point denotes change, but it does not indicate how that change will unfold. Work from evolutionary science provides a useful model for considering the path ahead through the Darwinian Gradualism or Punctuated Equilibrium Model first proposed by Niles Eldredge and Stephen Jay Gould.[6]

Why does the inflection point matter? Inflection points often represent existential risks as well as great opportunities. As in the example of transportation, the duration of each equilibrium is getting shorter and the disruption is happening faster. Market-leading incumbents lose out to new entrants not because they do not see risks and opportunities but because they focus on taking incremental steps in the existing framework or mindset. With approaching the inflection point in a "punctuated equilibrium" situation, it is critical to identify the inflection point and adopt drastic measures when necessary to mitigate risk as well as capture new opportunities.

Arguably, financial markets are facing an inflection point on climate change. The warning signs are coming from science, civil society, governments, and even the courts. The financial markets are rapidly responding, but the efficiency of that response is being hindered by lack of information and by misaligned incentives.

The "Why" for climate investing is very clear. It is driven by science, civil society, policymakers, and our desire to survive as a species. The "How" for ESG investing is very unclear. Investors do not have the tools nor the incentives to close the gap. Data standardisation and measures to align incentives are the two leading indicators for approaching the inflection point. The financial market is motivated and (mostly) efficient and the gap between demand and supply of ESG strategies is not sustainable, and we should be prepared for a disruption. The timing is evidently urgent. "Now" is the obvious answer.

In addition to the financial debt, how much more climate debt do we want to leave to the future generations? As we see the raging wildfires across the US Pacific Northwest alongside equatorial heat waves in temperate regions, and devastating floods in Europe, Japan and China, the physical impact of climate change is already with us. The question now is: can we do what is needed at the pace and scale? Can we close the gap?

Investors DIY

In response to the science and the changing regulatory landscape, investors have been gathering force both to call for regulatory action on corporate reporting and carbon pricing, whilst also taking to private ordering with the companies they invest in. One example is Climate Action 100+, which includes signatories investing over US$60 trillion assets under management and tackles the systemically important carbon emitters that form the third largest source of greenhouse gas emissions on the planet after China and the United States.

The investor focus goes beyond simply reporting; it includes board governance through demands for directors to demonstrate their "climate competence" and ensure internal incentives are aligned with the Paris accord goals through executive compensation targets and political lobbying policies to ensure a "just transition" that is financially viable and fair to workers and communities.

The demand from investors for the integration of climate risk and opportunity into corporate reporting is prompting a response from accounting standard-setting bodies both internationally and in the United States. Recognising the need to ensure that corporate reporting is both true and fair, both the SEC and IFRS are moving to develop the reporting standards, regulatory oversight, internal controls by audit committees and auditors that will be transformative in the financial markets' ability to price risk, allocate capital and exercise stewardship. Investors are taking matters into their own hands, not only calling on regulators to act with the urgency on information and incentives.

The Future: We Rise to the Challenge

The transition from a large number of small individual investors to a small number of large asset aggregators with acquired shareholder rights makes it possible for individual investors to exert influence collectively. This brings a private ordering force to bear which is intersecting with the national and global policy measures that are speeding change.

Both climate risk and the ongoing COVID-19 viral pandemic represent a systematic risk to humanity and demonstrate our vulnerability. Climate change and the pandemic are driven by molecules whose transmission does not respect national borders, which in turn requires collaboration at a global scale. How we, humanity, mobilized all the resources to rise to the challenge and develop effective vaccines in such a short time period is nothing short of extraordinary.

Science, policy, civil society, business and finance are all playing a critical role in partnership globally to tackle the pandemic. Similarly, the complex, urgent and global challenge of climate change requires cross-border, cross-sectoral partnership. With the advent of data driven by science, policy to remove of fossil fuel subsidies[7] and adoption of carbon pricing,[8] transformation to a low-carbon economy is not only possible but necessary. We can rise to the challenge of combating climate change, just as how we rose to the challenge of combating climate change of COVID-19 crisis.

1. Source: UN Sustainable Development Goals (n.d).

2. Source: Hale, J. (2021) U.S. Sustainable Funds Continued to Break Records in 2020; Morningstar.

3. Source: Nason, D. (2020) "Sustainable investing" is surging, accounting for 33% of total U.S. assets under management; CNBC.

4. Source: Barclays. (2020). ESG funds: Looking beyond the label; Barclays.com

5. Source: Peirce, H.M. (2021) Statement on the Staff ESG Risk Alert. U.S. SEC

6. Eldredge, N. & Gould, S.J. (1972). Punctuated equilibria: an alternative to phyletic. Models in Paleobiology, 82-115 Retrieved 18 July 2021, from https://thebrain.mcgill.ca/flash/capsules/outil_bleu09.html.

7. Source: Environmental and Energy Study Institute (29 July 2019) Fact Sheet| Fossil Fuel Subsidies: A Closer Look at Tax Breaks and Societal Costs. ESSI.org.

8. Source: The World Bank (n.d.) Pricing Carbon. Worldbank.orgs

About HKRSA

The Hong Kong Retirement Schemes Association (HKRSA) was established in 1996 to promote the interests and best practices of retirement schemes in Hong Kong including provident and pooled retirement funds. The HKRSA is a not-for-profit, non-political association, which represents retirement schemes and their members, providing a forum for discussion of issues of current and topical interest.

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